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## Russian Federation

### Solid Wood Products

### Outlook for Production and Trade of Forest Products in the Russian Far East

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**Report Highlights:**

In an effort to develop a modern forest products industry, the Russian government is making greater efforts to fight the high rate of illegal logging and stimulate the processing of high-value forest products. If the Russian Far East can combat these tough issues and more, it has the resource potential to double production on a sustained basis and to market an additional 10 million cubic meters (m3) of wood products in Asia.

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## Executive Summary

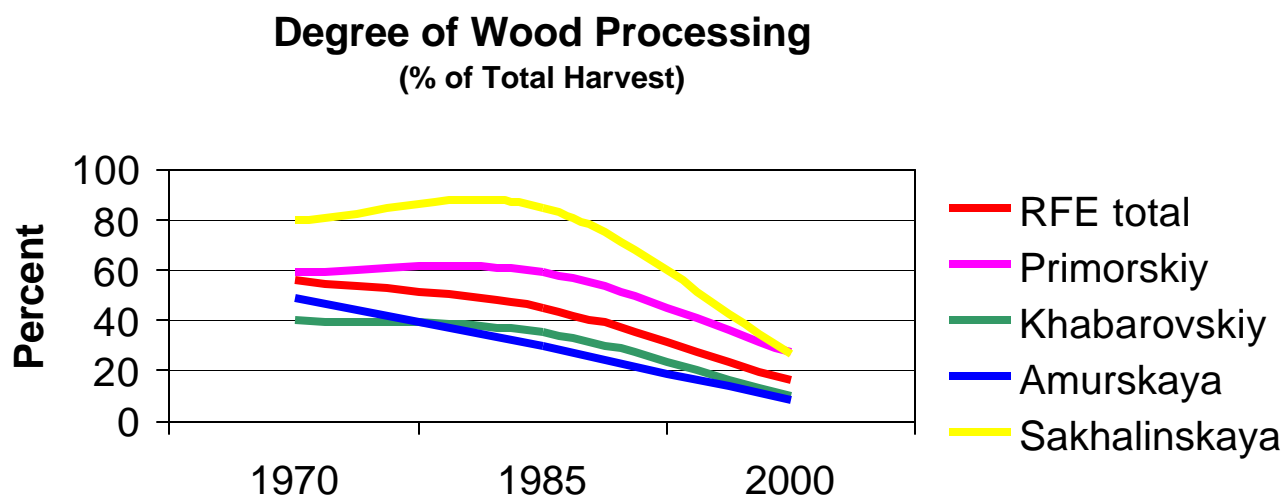
The Russian government is making greater efforts to fight the high rate of illegal logging, stimulate the processing of high-value forest products, restructure its forest service, and improve logging infrastructure in an effort to develop a modern forest products industry. In order to create an environment of investment and competition, illegal logging and exports must cease to undermine prices and the willingness to invest in further processing. The natural resource base in the Russian Far East is vast and can support much higher production, as the average cut in the 1980's was more than three times (26 million m<sup>3</sup>) more than current production. If Russia were to simply achieve its goals of increasing the processing rate, a mere increase of ten percent increase in the volume of wood processed would result in an additional 1.2 million m<sup>3</sup> of processed wood products (plywood, particleboard, etc) on the world market.

## The Forest Sector in the Russian Far East

The Russian Federation contains a staggering 25 percent of the world's forests. One quarter of this vast resource lies in the Russian Far East, where species of Siberian larch, spruce, and birch prevail, though there are also ash and oak hardwoods. Four provinces (Primorskii Krai, Khabarovsk Krai, Amur oblast, and Sakhalin oblast) represent the main base for production and trade of forest products in the RFE. The RFE also comprises another six provinces (Sakha Republic, Kamchatka oblast, Chukotka oblast, and Magadan oblast) grouped together as the northeast forest region. It is estimated that 40 percent of the Siberian and RFE forests remain economically inaccessible due to the difficult mountain landscape of the northern forest region.

The forests of the Russian Far East are one of the world's most important areas of natural forests as they are a significant reserve of carbon and biodiversity, an important economic asset for the livelihood of indigenous people, and hold a significant number of endangered plant and animal species. Preservation and sustainable use of these forests are of global importance and a challenge for regional governments as demand for Russian round wood from Japan and, particularly, China increased significantly in the past five years.

Table 1. Degree of Wood Processing in RFE (Source: Sten Nilsson, Supply Forecasts For Timber from the RFE and Links with the Pacific Rim Market.)



This situation poses a major management challenge to regional authorities because they are tasked with responsibility for a huge territory, but have few financial resources to enforce their forest management obligations. In brief, regional authorities are faced with a number of serious constraints. First, illegal logging is estimated at up to 50 percent of total production in certain areas and this functions as a disincentive to investment and sustainable forest management. Second, forest fires are increasing due to changes in the climatic conditions and lack of equipment. Lastly, the region generally suffers from inefficient and outdated processing facilities and a lack of infrastructure to access more forested areas. It is estimated that the region processes only ten percent of its production, and the remaining is sold as raw logs.

**Table 1. Final Harvest in the Russian Far East**

Thousand Cubic Meters

Year	Yakutiya (Sakha)	Primorskiy	Khabarovskiy	Amurskaya	Kamchatskaya	Magadanskaya	Sakhalinskaya	Yevr. Aut. Obl.	Chukotskiy Aut. Okrug	RFE Total
1948–1957	NA	NA	NA	NA	NA	NA	NA	NA	NA	22,281
1958–1967	NA	NA	NA	NA	NA	NA	NA	NA	NA	26,322
1968–1977	NA	NA	NA	NA	NA	NA	NA	NA	NA	34,912
1978–1987	NA	NA	NA	NA	NA	NA	NA	NA	NA	38,443
1990	3,402	4,789	11,593	5,571	718	245	2,926	341	12	29,598
1991	2,822	3,954	10,099	4,928	690	189	2,711	270	6	25,669
1992	2,194	3,490	8,164	4,201	558	147	2,631	209	1	21,594
1993	1,668	2,425	5,987	3,127	347	44	1,937	134	0	15,669
1994	1,055	1,782	3,683	1,838	204	23	1,439	92	0	10,116
1995	868	1,830	4,564	1,536	182	6	1,479	55	0	10,521
1996	697	1,455	4,340	1,231	137	2	1,143	50	0	9,055
1997	628	1,281	4,457	938	114	6	805	17	0	8,246
1998	456	1,449	3,325	602	127	5	426	12	0	6,400
1999	475	1,975	4,974	879	130	2	869	17	0	9,321
2000	589	2,200	5,825	827	140	1	872	26	0	10,482
2001	495	2,290	6,539	1,070	146	0	894	20	0	11,453
2002	358	2,416	7,121	1,138	126	1	918	76	0	12,153

Source: Compilation of Official Statistics, Alexander Sheingauz

While accurately estimating illegal logging is extremely difficult, the highest percent is generally focused near the border regions with China and areas where the logs can be shipped easily. Experts estimate that an aggregate of total regional illegal logging is much lower, approximately 20 percent. Using 20 percent illegal logging as an example, total actual logging would be closer to 14.6 million m<sup>3</sup> or 40 percent of the average harvests in the 1980's. Regardless of the actual production, forest surveys make it clear that Russia has the natural resource base to sustain more than a doubling of current production. However, the demand in the Russian Far East is very weak and European Russia markets are taken by geographically closer competitors (northern and Eastern Siberian regions), so the destinations for increased Russian Far East production would be almost exclusively export markets.

Would there be markets in the world that can accept another 15 million m<sup>3</sup> of Russian wood? According to international experts, the answer is most likely yes – China. According to much of the comparative data and wood balance projections for China, Japan, and South Korea presented in the study by Nilsson, Russia will be able to compete for a future Chinese market

of that much and more. Due to its location, Russia has the potential capture this market and continue to be the largest supplier to China.

Export prices for Russian logs (both hardwood and softwood) are on the rise and are driven mostly by firm demand from China and Korea and higher demand from Japan. According to market analysts, inventory levels at some mills in Japan are low. This situation forced Japanese importers to increase the volume of Russian logs imports by 17 percent during the first half of 2004, with the value of imports increasing by over 33 percent.

These upward trends in the export prices of Russian logs and lumber are likely to continue in the near future because of the rise in the stumpage fee for wood and charges for the certification program. It is not clear yet if environmental concerns will also affect export prices. Policy makers in Russia believe that higher short-term prices for logs and timber will provide added incentives for major development of the forest industry, mainly in the RFE, where constraints on timber harvests are still severe.

The other key question is the future composition of Russian exports. Most Russian companies certainly hope that ten percent is the low watermark in terms of further processing. However, though there is not much farther to fall, the answer will depend on increasing Russian processing efficiency, stemming the tide of illegal exports (of both legally and illegally harvested logs), energy prices, and infrastructure. Until these issues are solved and processing can be made to be profitable for the majority of the sector, log exports will continue to be the norm. While increasing the cost efficiency of processing may be easier in comparison to high wage importers such as Japan and South Korea, it will be difficult versus Russia's largest market – China. If such efficiency gains can happen, it would dramatically increase processed product exports to Japan and South Korea and tilt China away from a log importer to a processed wood product importer.

This would also have serious repercussions for competing countries, including the United States. For example, a mere increase of ten percent in the percent of wood processed would put 1.2 million m<sup>3</sup> of processed wood products (plywood, particleboard, etc) on the Asian market. As the Russian wood products industry in the Far East is currently at a crossroad, the direction it takes will have a profound impact on Asian wood product markets.

## **Major markets for Russian softwood logs**

### **China**

China's steady economic growth has resulted in significant increases in forest product imports over the last several years. Logs, lumber, and pulp are the most rapidly growing import segments as China increases domestic processing of forest products. Forest-rich countries in the Asia-Pacific region are playing an increasingly important role in supplying China's expanding demand. In a decade, China moved from a ranking of seventh up to the second position in total value of forest product imports and also is now the top importing country worldwide of industrial round wood.

It is estimated that domestic timber sources supply about 160 million m<sup>3</sup> and the rest comes from imports. The construction, furniture, interior, and paper sectors are the main consumers of wood products in China. Timber consumption in 2004 is forecast to remain high, driven by large-scale infrastructure construction projects, such as those for 2008 Olympics, Three-Gorges Dam project, Western Development program, housing construction, and home improvement/interiors.

Although the Chinese government has tried to increase its timber supply by developing fast-growing plantations, increasing efficiency of wood utilization, and promoting the use of wood substitutes, the gap between domestic timber supply and demand is high. Currently, China is short of large-diameter high-grade timber.

In 2003, imports of wood products set a new record and show no sign of slowing down in 2004. Round wood imports in 2003 reached 25 million m<sup>3</sup>, valued at \$2.4 billion, up by 4.6 percent versus 2002. Lumber imports in 2003 were 5.5 million m<sup>3</sup> and valued at \$1.2 billion, an increase of two percent in volume and three percent in value over 2002. About half of China's imports are hardwood species, which Russia cannot compete against due to the species structure and climate of the RFE's forests.

Softwood logs are imported primarily for use in construction, plywood manufacturing, materials handling and moulding industries. Russian softwood logs accounted for almost 92 percent of total imports of softwood logs, followed by New Zealand and Australia (its exports to China tripled over 2003).

Table 2. Trade In Softwood Logs and Lumber - Comparison Table (1,000 cubic meters)

Russian Exports to China				Chinese Imports From Russia			
	2001	2002	2003		2001	2002	2003
SW Logs	8,056	12,877	12,403	SW Logs	8,226	13,900	12,584
Total to World	23,903	28,373	28,028	Total From World	9,092	15,780	14,974
SW Lumber	191	501	485	SW Lumber	237	405	436
Total to World	5,950	6,996	10,156	Total From World	640	1,188	1,373

Border trade between the Russian Far East and the province of Heilongjiang is key for Russian exports of logs, accounting for estimated 87 percent of trade with China. Low transportation costs and the use of Chinese labor to harvest Russian trees provide a substantial price advantage for producers. As a result, Russian logs are much cheaper than those from North America or New Zealand. According to Russian export statistics, exports of softwood logs to China were 12.4 million cubic meters in 2003. However, Chinese import data shows 12.6 million metric tons for the same period. Thus, there is minor 0.1 million cubic meter difference between the statistics of each country, in comparison to a sizable difference of 1.2 million m<sup>3</sup> in 2002.

Despite the fact that Russian and Chinese official statistics are quite close, most experts agree that there is significant smuggling and illegal harvest of logs along the border, which if taken into consideration reveals a much higher level of real trade. Experts think that there are significant irregularities in terms of customs enforcement on both sides of the border. Essentially, when illegally harvested Russian wood crosses the border, it is unlikely to become "legalized" by being registered as imports by Chinese customs. This is fostered by a long border and weakness in customs enforcement on both sides.

## Japan

Japan is the third (after Finland and China) largest importer of wood products from Russia, mainly of softwood logs. Total log exports from Russia to Japan are estimated at 17 percent of overall solid wood log exports and accounted at 4,701 m<sup>3</sup> in 2003, up almost four percent from 2002. Trade in 2003 rebounded after a decline in volume of approximately 250,000 m<sup>3</sup> in 2002.

As the Japanese domestic plywood manufacturing industry has shifted from hardwood to softwood plywood production, manufacturers are increasingly using Russian larch. Imports of larch, the predominant species imported from Russia, were up 10.4 percent in 2003. Larch accounted for 46.5 percent of Japanese log imports from Russia.

Imports of sawn and manufactured softwood products grew more than ten percent from the previous year. This is mainly attributed to the fact that Japanese manufacturers are shifting production offshore to Russia, where they invest in financial and technical assistance for Russian production facilities.

Table 3. Trade In Softwood Logs and Lumber - Comparison Table (1,000 cubic meters)

Russian Exports to Japan				Japanese Imports from Russia			
	2001	2002	2003		2001	2002	2003
SW Logs	5,036	4,533	4,701	SW Logs	4,989	4,746	4,844
Total to World	23,903	28,373	28,028	Total From World	11,295	12,923	10,465
SW Lumber	406	647	813	SW Lumber	596	694	818
Total to World	5,950	6,996	10,156	Total From World	8,027	8,925	8,077

### Illegal logging in the Russian Far East

Trade statistics and reports on forest production and trade from exporting countries suggest that China is one of the major destinations for illegally harvested timber. The fast growth of Chinese imports of wood product imports will continue to impact on forests and the livelihoods of millions of forest-dependent people throughout Asia-Pacific and the world. According to the Center for International Trade in Forest Trade at the University of Washington, by 2025 China could face a deficit of 200 million m<sup>3</sup> of wood per year. To meet this demand, China is looking northward to Russia where about 41 percent of China's total log imports currently originate.

According to official statistics for 2000-2003, the volume of illegal logging in Russia accounts for only 0.4-0.6 percent out of the legal logging volume. However, as mentioned earlier, the volume of timber poaching more likely between 20-50 percent. Illegal logging is flourishing in the Russian Far East and the lack of enforcement of customs and forest regulation is apparent on all levels. The World Wildlife Fund published information claiming that the real turnover in forestry business in Russia is \$6 billion and losses due to illegal activity are \$1 billion. Official data provided by Federal Agency for Forestry of report only \$1.5 billion and \$180 million, respectively.

Greenpeace Russia breaks down illegal logging in the following categories for all of Russia:

1. Unauthorized logging, or timber poaching. Official statistics do not exist. It is estimated at ten percent of total logging;
2. Felling operations aimed at removing only the best sorts of wood, or disguised sanitation felling, which is estimated at 30 percent of the total logging;

3. Logging outside of concession boundaries. It often happens due to incorrect assignment of the logging site boundaries. According to existing provisions, tree farm representatives should check all logging sites after a logging firm has completed its felling operations. If any of the requirements stated in the logging ticket have been breached, forest harvesters theoretically incur penalties.

It is extremely difficult for Russian government authorities to monitor the large number of small-scale timber operations, which often exist for one or two years, conduct their illegal logging and trade activities, and disappear before authorities can catch them at illegal harvesting or not paying taxes. As a result of this, a government objective is to decrease the number of small companies involved in the forestry business and create favorable business conditions for larger ones.

Other possible measures under consideration by the regional governments include:

- Establishing a forestry police structure that will combat poaching and illegal harvesting;
- Export product certification;
- Bar coding of timber products, so that any oversight agency (police, Customs, etc.) could trace the logs.

The Ministry of Natural Resources believes that increased export duties for raw logs and decreased duties for processed forestry products could become an incentive to legalize business operations and attract badly needed investment. Thus, the Interdepartmental Commission for Protective Measures in Foreign Trade and Custom Tariff Policies approved a decision to lower export duties to five percent from ten percent on wood cellulose and increase import duties for furniture by 20 percent. However, this effort relies heavily on an effective border service.

### **Economic Impact of Illegal Logging**

In addition to the obvious negative impact on the Russian economy in terms of tax evasion and revenues, illegal logging also affects trade for competing exporters, such as the United States. This is especially true in Asia. Illegal logging poses problems for competitors because these materials are sold below production cost. Illegal businesses do not pay taxes or customs duties, conduct mandatory replanting and environmental conservation activities, or comply with social obligations and community development.

Although it is quite difficult to quantify, clearly foreign and legal Russian businesses and Russian communities would benefit if this unfair competitive business were legalized. Besides, it has become difficult for legal timber companies to survive the competition of illegal operators, due to difficulty to enforce timber harvest regulations and collect stumpage and licensing fees.

Use of illegal imported wood also gives producers in importing countries, such as China, a competitive advantage due to the low costs of raw materials. Low raw material costs help those producers compete more successfully in their own domestic market and in exporting finished goods using that wood.

### **View from the Regional Government Perspective**

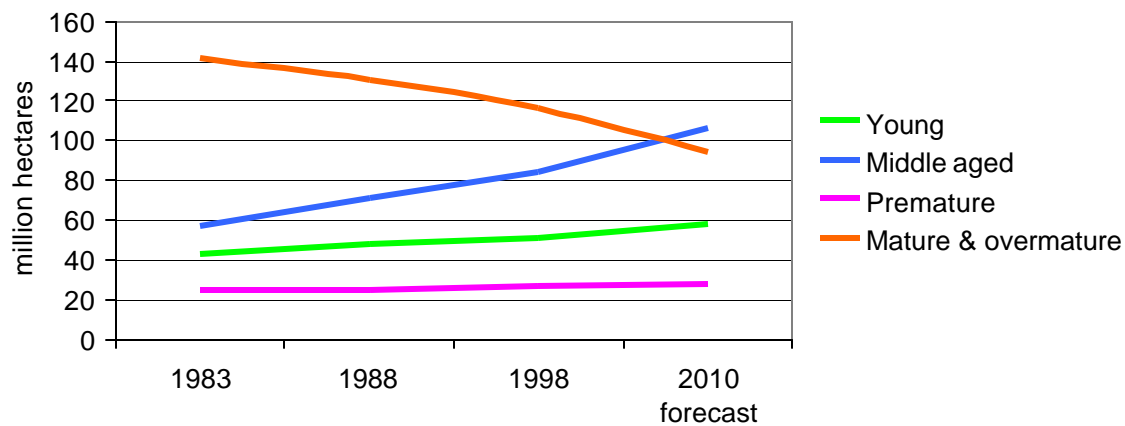
According to industry representatives interviewed in Khabarovsk krai, in order to overcome these constraints, cooperation is needed among all players of the forest sector. The following

principles of sustainable forest management were discussed and are being adopted by regional government:

- Stimulate the merger of smaller logging companies by strengthening their capabilities to provide adequate supply of raw materials. This objective also implies the strengthening of forest management to protect forest resources from increasing forest fires and illegal logging;
- Stimulate more investments in the sector in order to improve and upgrade equipment and machinery, and bring new technology;
- Reduce illegal timber trade between Russia and China. This is a difficult policy issue to be resolved by the regional governments, partly because of the overlapping responsibilities of federal agencies in the border/customs enforcement. Local representatives noted that a long-term solution to this problem requires international cooperation of the three other Pacific Rim countries (China, Korea, and Japan);
- The other major vital issue for the RFE is the regulation of energy prices, which can directly affect the profitability of forestry sector in the area and affect the level of investment in the local industry. Energy prices are on the rise and the costs of processing timber are not being offset by increased efficiency or use of production waste. Normally, production would be somewhat isolated from energy prices by the utilization of processing waste as fuel for "biomass" generators to run kilns and processing equipment. This equipment is completely absent in the major Russian Far East processors, so they will have to live with the climbing energy prices resulting from energy price deregulation in Russia.

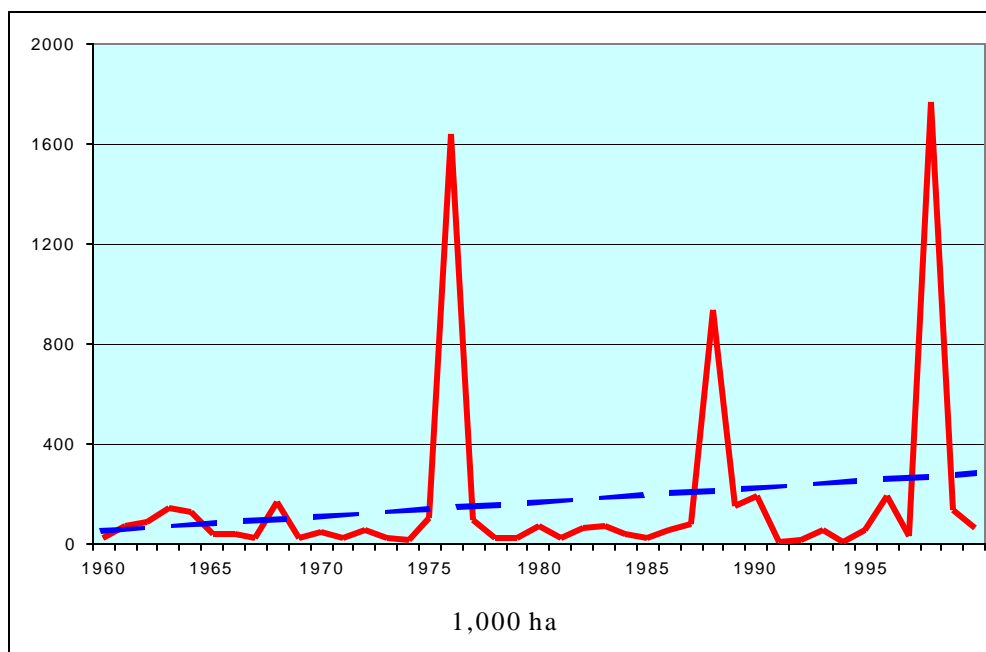
The lucrative Chinese, Japanese, and Korean markets for processed timber are not fully accessed because of the high processing costs. East Siberia's (Irkutsk oblast) cheap energy allows its producers to capture a large part of the Chinese market for processed wood products, while Khabarovsk producers cannot compete against efficient wood processors in Japan or South Korea. This is one of the reasons for the continued high rate of illegal round wood exported from Khabarovsk krai.

### Age Structure of Density Forests in the RFE



Source: Major Trends in Forests and Forestry Globally and Russia. Jim Ford and Alexander Sheingauz. Forest Trends, Economic Research Institute.

### Forest Fires in Khabarovskiy Krai, 1960-2000.



Source: Main Directions of the Development of Forest Industry of Khabarovskiy Krai. Alexander Sheingauz, Institute for Economic Research of the Russian Academy of Science in Khabarovsk.

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